Exercise 6 (Chapter 12 and 16)
(ECON 410, Spring 2009)
(Optional, due 04/28/2009)

(A) Multiple Choice Questions: (3 points per multiple choice problem), 25 questions.

1. The consumer's budget constraint reflects the fact:
A) Current consumption should equal the current income.
B) Future consumption should equal the future income.
C) Present value of current and future consumption should equal present value of current and future income.
D) The consumer does not borrow money.

2. When the consumer has chosen his or her optimal values of first-period and second-period consumption, he finds that he doesn't have to borrow or save. Now an increase in interest rate will make the consumer to:
A) Borrow in the first period.
B) Save in the first period.
C) Stay the same.
D) Could be any one of the above.

3. An increase in income in period one in Irving Fisher's two-period consumption model increases consumption in:
A) period one, but decreases consumption in period two.
B) period one, but does not change consumption in period two.
C) both periods one and two, as long as consumption in period one and consumption in period two are both normal goods.
D) period two, but does not change consumption in period one.

4. In Irving Fisher's two-period model, if the consumer is initially a saver and the interest rate increases, and first-period consumption decreases, then we can conclude that the income effect:
A) was greater than the substitution effect.
B) was less than the substitution effect.
C) exactly offset the substitution effect.
D) and the substitution both decreased consumption.

5. Franco Modigliani's life-cycle hypothesis puts great emphasis on saving for:
A) a house.
B) a car.
C) retirement.
D) medical emergencies.

6. According to Modigliani's life-cycle hypothesis, if a consumer wants equal consumption in every year and the interest rate is zero, then the marginal propensity to consume out of wealth ______ as years ______ decrease.
A) increases; of life remaining
B) decreases; of life remaining
C) increases; until retirement
D) decreases; until retirement

7. According to the permanent-income hypothesis, consumption depends primarily on ______ income.
A) current
B) nominal
C) permanent
D) transitory

8. In Irving Fisher's two-period consumption model if Y_1 = 20,000, Y_2 = 15,000, and the interest rate r is 0.50 (50 percent), then the maximum possible consumption in period two is:
A) 15,000.
B) 25,000.
C) 35,000.
D) 45,000.

9. A two-year old prefers one ice-cream right now than two ice-cream 10 minutes later. Economists say:
A) The two-year-old violates utility maximization.
B) The two-year-old values current consumption much more than future's consumption.
C) The two-year-old prefers playing to ice-cream 10 minutes later.
D) The two-year-old does not behave rationally.

10. In a small, open economy with a floating exchange rate, an effective policy to increase equilibrium output is to:
A) increase government spending.
B) increase taxes.
C) increase the money supply.
D) decrease the money supply.

11. In a small open economy with a floating exchange rate, a rise in government spending in the new short-run equilibrium:
A) chokes off investment, but not by as much as the new government spending.
B) chokes off an amount of investment just equal to the new government spending.
C) attracts foreign capital, thus raising the exchange rate and reducing net exports, but not by as much as the new government spending.
D) attracts foreign capital, thus raising the exchange rate and reducing net exports by an amount just equal to the new government spending.

12. In a small open economy with a floating exchange rate, the supply of real money balances is fixed and a rise in government spending:
A) raises the interest rate, so that income must rise to maintain equilibrium in the money market.
B) raises the interest rate so that net exports must fall to maintain equilibrium in the goods market.
C) cannot change the interest rate so that net exports must fall to maintain equilibrium in the goods market.
D) cannot change the interest rate so income must rise to maintain equilibrium in the money market.

13. Under a fixed system, the exchange rate:
A) fluctuates in response to changing economic conditions.
B) is maintained at a predetermined level by the central bank.
C) is changed at regular intervals by the central bank.
D) fluctuates in response to changes in the price of gold.

14. If there is a fixed-exchange-rate system, then in the short run described by the Mundell-Fleming model:
A) the nominal exchange rate is fixed, but the real exchange rate is free to vary.
B) the real exchange rate is fixed, but the nominal exchange rate is free to vary.
C) both the nominal and real exchange rates are fixed.
D) the nominal exchange rate is fixed, but whether the real exchange rate is fixed depends on whether the central bank follows a rule of constant growth of the money supply.

15. In a small open economy with a fixed exchange rate, if the government increases government purchases, then in the process of adjusting to the new short-run equilibrium the money supply:
A) increases to keep the exchange rate unchanged, thus augmenting the effect of government spending on income.
B) decreases to keep the exchange rate unchanged, thus offsetting the effect of government spending on income.
C) remains unchanged, and there is no effect of government spending on income.
D) remains unchanged to keep the interest rate at the world interest, so that government spending reduces income.

16. According to the Mundell-Fleming model, under flexible exchange rates expansionary monetary policy ______ increase income and under fixed exchange rates expansionary monetary policy ______ increase income.
A) can; can
B) can; cannot
C) cannot; can
D) cannot; cannot

17. In the Mundell-Fleming model, if the price level falls, then the equilibrium income
A) rises and the real exchange rate appreciates.
B) rises and the real exchange rate depreciates.
C) falls and the real exchange rate appreciates.
D) falls and the real exchange rate depreciates.

18. Given that almost everybody knows the bad health consequence of smoking,
A) A non-smoker is more rational than a smoker.
B) A smoker is richer than a non-smoker since he can afford additional consumption in cigarettes.
C) A non-smoker values future utility higher than a smoker.
D) A smoker is a more disciplined person.

19. In the Mundell-Fleming model with a floating exchange rate, a rise in the world interest rate will lead income:
A) and net exports both to fall.
B) to rise and net exports to fall.
C) to fall and net exports to rise.
D) and net exports both to rise.

20. According to the permanent-income hypothesis, if consumers receive a one-time income bonus, then they will:
A) save most of it in the current year.
B) spend most of it in the current year.
C) spend one half of it and save one-half of it in the current year.
D) not alter their consumption or saving in the current year.

21. According to Friedman's permanent-income hypothesis, the marginal propensity to consume out of permanent income is ______ the marginal propensity to consume out of transitory income.
A) greater than
B) less than
C) equal to
D) one minus

22. If consumers have rational expectations and follow the permanent-income hypothesis, their current consumption will increase when:
A) previously announced tax reductions are implemented.
B) they receive an anticipated raise.
C) they receive an unexpected inheritance.
D) they make the last payment on their automobile loan.

23. If consumers obey the permanent-income hypothesis and have rational expectations, then policy changes affect consumption when the policy changes:
A) are proposed.
B) go into effect.
C) change expectations.
D) do not surprise consumers.

24. If a consumer is a borrower in period one and the interest rate rises, the:
A) income and substitution effects both tend to make consumption higher in the first period.
B) income and substitution effects both tend to make consumption lower in the first period.
C) income effect tends to make consumption higher in the first period and the substitution effect tends to make it lower.
D) substitution effect tends to make consumption higher in the first period and the income effect tends to make it lower.

25. A binding borrowing constraint will ______ the potency of an announced future tax cut to influence aggregate demand but will ______ the potency of a temporary tax cut.
A) not affect; increase
B) increase; not affect
C) decrease; increase
D) increase; decrease

Essay Questions

1. (15 points)
Mankiw textbook, Chapter 16, question 3, pp 485.

2. (10 points)
Mankiw textbook, Chapter 16, question 4, pp 485.